A Deep-Value Retail Strategy

Marc H. Gerstein July 24, 2008

Dogs of the Dow may be the most widely known bottom-fishing value strategy but it's definitely not the first and probably not the best. Portfolio123 member Wayne Nef used an earlier Templeton approach (buy all NYSE stocks priced at or below $1) as a starting point for a deep-value retail-stock strategy that has generated an eye-catching performance record.

The Templeton-Nef strategy

Nef, through his firm Nef Value Research LLC, does not work with stock price the way Templeton did, but his approach shares the latter's Depression-era philosophy, bottom-fishing based on a belief that even though some companies would go bankrupt, there would be enough winners make the overall portfolio a success. As it turned out, Templeton succeeded handsomely when he invested that way.

Nef's retail-stock version of that strategy is two-prong. Like Templeton, he seeks beaten-down issues, defined here not by stock price but through two widely-used valuation metrics. He requires that Price/Sales and Price/Book ratios both be less than 1.00. Price/Book ratios that low are especially telling, since retailers rarely trade at those levels for prolonged periods. (Looking at the present retail stock universe, only 58 out of 202 stocks have such low Price/Book ratios despite the beating the group has already experienced. If we eliminate issues with market capitalizations below $100 million, we find 35 out of 169 issues priced below book value.) Add in a low Price/Sales, and we have stocks the market clearly has brushed aside.

A pure value strategy would stop there. Clearly, such a list would be heavily-populated with dogs. Maybe there will be enough winners sprinkled in to enable an investor to enjoy the Templeton experience. Maybe not.

Rather than simply rolling the dice, Nef seeks to tilt the probabilities in his favor by adding a fundamental component to his model. This consists of two rules both geared toward financial strength. He seeks companies with long-term-debt to equity ratios below 50% and current ratios above 2.00. The latter influences the willingness of lenders to extend trade credit, a potentially critical factor since liquidity, rather than leverage per se, can be the key to whether a struggling retailer keeps going or has to throw in the towel.

Before recommending an individual stock from such a list to his clients, Nef goes further and seeks specific catalysts that suggest the abnormally-low valuation will soon be corrected. But we decided to create a Portfolio123.com simulation to see how this approach might fare if applied as an automated rules-based strategy. In that context, Nef decided to limit the portfolio to about 12 positions and to take only the largest issues, from a market-capitalization standpoint, during those periods when the above screen produced too many stocks. That is consistent with the belief held by many that in the struggling-company arena, size is another factor that relates to survivability.

In terms of sell rules, Nef shifted gears a bit. He was not forgiving of deterioration in Current or Long-Term-Debt ratio. If either slipped below that threshold specified in his buy rules (2.00 or 50% respectively), the stock was sold. But he did not eliminate existing positions whose Price/book or Price/Sales ratios moved above 1.00. Hence he rode his winners. Many who ride winners do so as part of a strategy that also involves selling losers. Nef tested this with stop-losses. Ultimately, however, a portfolio like this did best with patience. The strongest test results occurred when no stop loss was used, so no such factor was included in the final set of sell rules.

The simulation was set to begin 3/31/01 and run through the present. Portfolio rebalancing was set to four weeks and commission was assumed to be $7.00 per trade.

Simulated performance

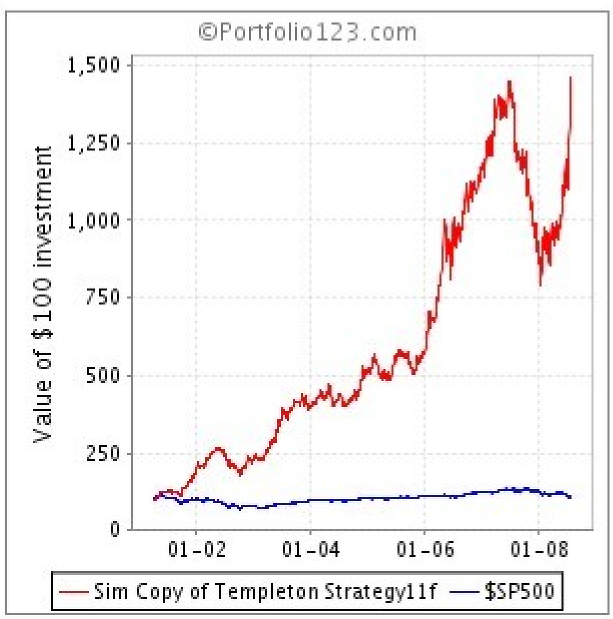
Figure 1 details the performance record of the Portfolio123.com simulation.

Figure 1

Performance		
Return	Model	S&P 500
Total	1,325.73 %	11.44 %
Annualized	43.84 %	1.49 %
Year To Date	54.77 %	-13.03 %
4 Week	23.19 %	-2.84 %
13 Week	51.42 %	-7.19 %
1 Year	3.32 %	-17.16 %
3 Year	147.02 %	3.90 %

Figure 2 shows a basic graphical view of performance which, admittedly, looks quite jarring in the recent past.

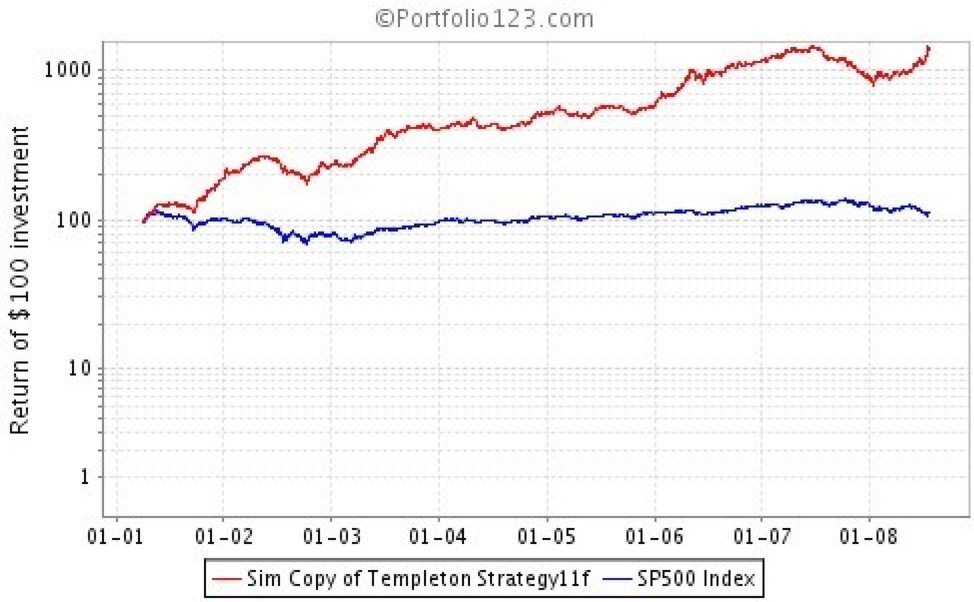
Figure 2



The peak-to-trough price return from 6/27/07 through 1/15/08 was minus 45 percent. When one actively seeks out-of-favor sticks, as Nef does with his valuation rules, this sort of thing comes with the territory. The vigorous snapback since 1/15/08 represents the flip side; the fact that the companies had more financial strength than their late-2007 stock price trends implied.

Figure 3, a logarithmic scale, presents a different perspective.

Figure 3



Notice how, from the 2002-03 period, how the S&P 500 continued to languish after the portfolio completed its 5/15/02 through 10/9/02 peak-to-trough 35 percent fall. While the index also started to improve after 10/9/02, it lagged and came close to re-testing its low as late as 3/11/03. The portfolio, on the other hand, turned up from the 10/02 low and didn't look back.

It's interesting to wonder if we're seeing something similar right now. The portfolio soared since 1/15/08; perhaps enough so we might not be surprised to see a correction. But whether that happens or not, it is clear that since the last trough, the portfolio has, again, been leading the S&P 500.

Today, it's easy to recite the sizable litany of financial and economic dislocations that have not yet been solved and to suggest that the portfolio has enjoyed a false rally. I recall, however, much the same climate in 2003, including the typically incredulous and sometimes hostile reactions I got when I tried to explain bullish positions in conversations with financial reporters. Also, recall the strategy of the Nef-Templeton model. There are no rose-colored glasses. Nef knows he's looking for struggling companies; his twist is to seek objective indications of survivability.

As noted above, Nef adds his own judgment as to the presence of catalysts before recommending stocks to his clients. But the hedge-fund aura surrounding this approach is visible even in the automated version of this simple strategy. Figure 4 shows how on a month to month basis, this portfolio has tended to chart its own course, with little regard to what the overall market has been doing, how there have been noteworthy instances of big declines even during bullish periods, but also how most of the idiosyncratic volatility has been on the upside.

Figure 4

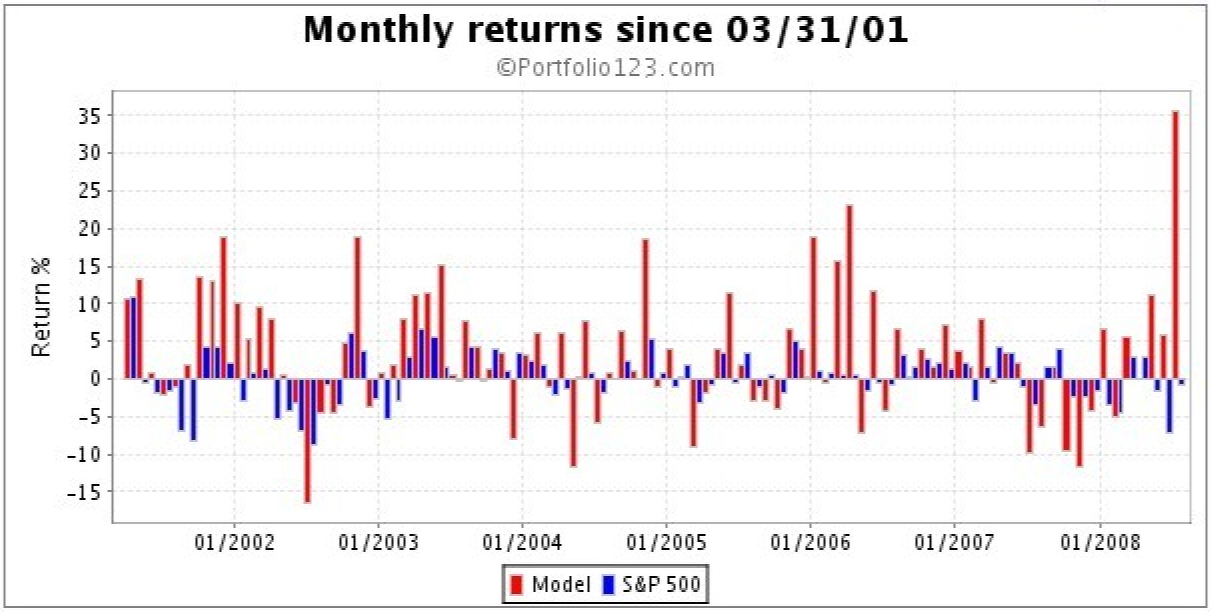


Table 1 quantifies those trends.

Table 1

	Strategy Relative to . . .	
	S&P 500	**Russell 2000**
Correlation	0.46	0.53
R-Square	0.22	0.28
Beta	0.70	0.66
Alpha (annualized)	40.95%	37.42%

We see exactly what hedge funds cherish; low correlation, low beta, and high alpha.

The present stock list

This is not the exact Nef Value Research recommended list. It's the present stock list generated by the automated Portfolio123.com version of the strategy, the one whose simulation results were presented above.

Nef's Templeton Strategy: Retail Plays
Charming Shoppes, Inc. (CHRS)
The Finish Line, Inc. (FINL)
Foot Locker, Inc. (FL)
Fred's, Inc. (FRED)
99 Cents Only Stores (NDN)
Rex Stores Corporation (RSC)
Shoe Carnival, Inc. (SCVL)
Stage Stores, Inc. (SSI)
ValueVision Media, Inc. (VVTV)
West Marine, Inc. (WMAR)
Zale Corporation (ZLC)

(Wayne Nef can be reached at wayne_nef@nefvalueresearch.com.)
